ORIGINAL

Before the
Federal Communications Commission
Washington, DC 20554

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In the Matter of	)	
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Prescribing the Authorized Unitary Rate of Return for Interstate Services of Local Exchange Carriers	)	CC Docket No. 98-166

DIRECT CASE OF THE VIRGIN ISLANDS TELEPHONE COMPANY

Gregory J. Vogt
Bryan N. Tramont
WILEY, REIN & FIELDING
1776 K Street, N.W.
Washington, D.C. 20006
(202) 429-7000

Attorneys for Virgin Islands Telephone Corporation

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The Virgin Islands Telephone Corporation ("Vitelco") through its undersigned counsel, respectfully submits its direct case and comments in the above-captioned prescription proceeding, pursuant to 47 C.F.R. §§ 65.103 (b), 65.104(a) and 65.105(a).

As detailed in the Notice, this proceeding was commenced to "represcribe the authorized rate of return for interstate access services provided by" incumbent local exchange carriers (ILECs).[1] The Commission's Notice was prompted by a consecutive six month period in which yields on 10-year U.S. Treasury securities remained more than 150 basis points below the reference point of 8.64 percent.[2]

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[1] *Prescribing the Authorized Unitary Rate of Return for Interstate Services of Local Exchange Carriers*, Notice Initiating a Prescription Proceeding and Notice of Proposed Rulemaking, CC Docket No. 98-166, FCC 98-222 at 2, ¶ 1 (Oct. 5, 1998) (*"Notice"*).

[2] *Id.*, at 3, ¶ 2.

INTRODUCTION AND SUMMARY

Vitelco is a small rural incumbent local exchange carrier providing service in the United States Virgin Islands. Vitelco's customers are dispersed over an area replete with natural barriers that impose significant additional costs on telephone service. In addition to the high costs imposed by the topography of the islands, Vitelco's costs are also vastly increased by the impact of natural disasters, such as hurricanes. Thus, like many other insular carriers, Vitelco is highly dependent on universal service support and other subsidy mechanisms in order to provide affordable service, particularly to its residential customers. These factors make Vitelco's business and investment climate particularly vulnerable to shifts in regulatory policy.

Vitelco believes this proceeding is, at best, premature. Local exchange carriers, like Vitelco, that are subject to the unitary rate of return are entering into an unprecedented era of regulatory and commercial upheaval. The full impact of these changes is not likely to be felt in the near future. Rather than tinkering with the existing rate of return regulatory regime, the public interest would be far better served by focusing the Commission's limited resources on defining and moving towards the new competitive paradigm. As Commissioner Furchgott-Roth noted: this proceeding "is a mere vestige of outdated rate of return regulation. In today's increasingly competitive environment, the Commission should be focusing its efforts on transitioning to a more competitive environment. . . . "[3]

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[3] *Id.*, Dissenting Statement of Commissioner Furchgott-Roth.

Based on the regulatory uncertainty generated by the major policy issues still pending at the Commission and the imminent development of competition in these markets, it will be difficult, if not impossible, to develop a unitary rate that will accurately capture the cost of capital for the evolving competitive marketplace. Indeed, development of a rate prescription today will not eliminate the need to initiate another rate prescription proceeding as soon as the Commission's pending policies are defined and implemented. Ironically, not only does this proceeding divert valuable resources away from other Commission initiatives and attempt to hit a fast-changing cost of capital target, this proceeding may actually serve to slow the development of the Commission's ultimate competitive goals. Rather than mechanically altering the rate of return initiated by an anachronistic trigger mechanism, the Commission should evaluate the totality of the regulatory and market landscape and leave the current rate prescription alone until the effects of the current regulatory and competitive upheaval becomes more predictable. Thus, in light of the substantial work yet to be done in paving the highway to competition, the Commission should not now direct its attention to pouring new rock on the old rate of return gravel road.

I. Current Regulatory Upheaval Undermines the Commission's Ability to Represcribe an Accurate Unitary Rate of Return.

As the Commission is well aware, these are tumultuous times for smaller insular local exchange carriers, like Vitelco. All incumbent local exchange carriers are facing a dizzying array of new responsibilities. Yet a variety of factors have colluded to delay the day when the rules of this new regime are set, especially for smaller rural carriers. The extensive time necessary for the agency to render its decisions, combined with court challenges and petitions for reconsideration, have inevitably delayed addressing the unique issues posed by smaller carriers.[4] Until the rules have been defined, it is difficult, if not impossible, to predict how capital markets will assess the riskiness of investment in small rural local carriers.

Central to this uncertainty are the pending universal service and access charge reform dockets.[5] Universal service and access charges are fundamental to Vitelco's profitability. Yet many of the basic issues in these dockets remain unresolved.

Universal service policies for rural carriers are almost a complete mystery. Although today the Commission is moving closer to establishing a cost model for non-rural LECs, that process is not yet complete and will undoubtedly be subjected to further appeal, tinkering and delay.[6] The Commission has not even begun this complex cost modeling process for rural carriers.[7] These rural cost model issues are still

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[4] *See e.g. Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd 15499 (1996), *vacated in part, Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997), *cert. granted,* 118 S. Ct. 879 (U.S. Jan. 26, 1998)(Nos. 97-826, et al.).

[5] *See, e.g., Access Charge Reform*, First Report and Order, 12 FCC Rcd 15982 (1997); Order on Reconsideration, 12 FCC Rcd 10119 (1997), *aff'd sub nom Southwestern Bell Telephone Co. v. FCC*, 153 F.3d 523 (8th Cir. 1998); Second Order on Reconsideration, 12 FCC Rcd 16606 (1997). *See also Federal-State Joint Board on Universal Service*, Report and Order, 12 FCC Rcd 8776 (1997), *appeal pending sub nom. Texas Office of Public Utility Counsel v. FCC*, No. 97-60421 (5th Cir. argued Dec. 1, 1998); *Federal-State Joint Board on Universal Service*, Second Recommended Decision, CC Docket No. 96-45, FCC 98J-7 (Nov. 25, 1998). (*"Second Recommended Decision"*)

[6] *See Forward-Looking Mechanism for High Cost Support for Non-Rural LECs,* Further Notice of Proposed Rulemaking, 12 FCC Rcd 18514 (1997).

[7] *See Second Recommended Decision* at 15, ¶ 30.

awaiting a Task Force recommendation on how to structure such a system.[8] Once the recommendation has been forwarded, it will be considered, possibly altered and eventually approved by the Joint Board.[9] Only then will the Commission expose the model to public comment. Then the FCC must decide whether to adopt such a recommendation. Therefore, on the key issue of how rural customer costs will be determined, the Commission has barely left the starting gate. Similarly, the Commission has yet to determine the appropriate benchmark for use in computing universal service support levels.[10] This benchmark is also a key element of universal service. Absent resolution of issues such as cost models and benchmarks, LECs and the capital markets have no ability even to guess at the level of universal service support that will be available. Such uncertainty leads inexorably to market volatility, which, in turn, make rate of return represcription difficult and ill-advised.[11]

The serious risks posed to carriers like Vitelco by universal service changes are far-reaching and significant. For example, Vitelco estimates that universal service support will account for approximately 33% of its 1999 total intrastate revenue. The fate of these monies is completely unknown. Capital markets are, at best, skittish at the

[8] *See Id.*

[9] *See Id.*

[10] *See Federal-State Joint Board on Universal Service*, 12 FCC Rcd 8776 (1997).

[11] Vitelco recognizes that it is currently exempt from some obligations under the Act. Yet this exemption is subject to regulatory removal by state commissions. 47 U.S.C. § 251(f). Thus the ultimate resolution of these regulatory matters is likely to have a long term impact on smaller rural carriers as well.

prospect of a company being so dependent on funding of an uncertain amount on a going forward basis. An accurate assessment of the rate of return necessary for smaller rural carriers to attract capital cannot be made until these universal service building blocks have been set.[12]

Access charge reform is similarly in flux. Although some initial decisions have been made for price cap companies, the Commission is yet to address pricing flexibility, special embedded cost recovery and other important issues.[13] Moreover, while the Commission has issued an NPRM regarding access charge reform for rate of return carriers, which would control Vitelco's access rates, the Commission is yet to issue an order resolving these issues.[14] Nor is there any schedule for such a decision. Access charges are particularly important to small rural telecommunications providers because they represent a high percentage of these carriers' overall revenues.

Aside from pending matters, the 1996 Act has also imposed a series of costly obligations on small local telephone companies that have not yet been fully implemented and assessed by the capital markets. These costly obligations include consumer proprietary network information protections and limitations, CALEA

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[12] The Commission has estimated that universal service support levels for rural carriers will not be modified for the new competitive era until "January 1, 2001, at the earliest." *Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate of Return Regulation*, CC Docket No. 98-77, FCC 98-101 at 13, ¶ 34 (June 4, 1998) (*"Access Charge Reform for ILECs"*).

[13] *Access Charge Reform*, First Report and Order, 12 FCC Rcd 15982 (1997).

[14] *See Access Charge Reform for ILECs*, at 13, ¶ 34.

requirements, and local number portability.[15] Indeed, Vitelco was recently forced to upgrade its switches in significant part due to new obligations imposed by the Act. Vitelco's 1999 budget allots over 30% of its costs to capital improvements related to these mandates. These costs make it that much more difficult for smaller rural carriers to attract capital at this vital time.

Regulatory uncertainty regarding core issues under the 1996 Act combined with costly new mandates counsel the FCC to be cautious and refrain from needlessly attempting to set the rate of return in these uncertain times.

II. Competition Will Substantially Change the Cost of Capital Forever.

The 1996 Act fundamentally and forever changed the nature of the bargain for all telecommunications investors. The Commission last altered the prescribed rate of return back in 1990. Both the theory and mechanism behind the 1990 rate were based on a vastly different regulatory and technological environment. The changes brought about by the 1996 Act are perhaps most pronounced for those carriers subject to rate of return prescription. Formerly, investors knew that smaller rural carriers were incumbent

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[15] *See Implementation of the Telecommunications Act of 1996: Telecommunications Carriers' Use of Customer Proprietary Network Information and Other Customer Information; Implementation of the Non-Accounting Safeguards of Section 271 and 272 of the Communications Act of 1934, as amended*, CC Docket Nos. 96-115 and 96-149, Second Report and Order and Further Notice of Proposed Rulemaking, 13 FCC Rcd 8061 (1998); *Communications Assistance for Law Enforcement Act*, Further Notice of Proposed Rulemaking, CC Docket No. 97-213, FCC 98-282 (Nov. 5, 1998); *Telephone Number Portability*, Third Report and Order, CC Docket No. 95-116, FCC 98-82 (May 12, 1998).

monopoly providers with fairly predictable risks and benefits. Today that predictability is drowning in a sea of volatility.

All across the country, the Big Three competitive giants (AT&T, MCI-Worldcom and Sprint) are threatening the customer bases of smaller rural carriers like Vitelco. Indeed, AT&T has signaled an apparent intention to compete directly in the U.S. Virgin Islands.[16] These competitive Goliaths will bring increased and unknown risks to smaller rural carriers. Small carriers are particularly vulnerable to the Big Three's strategy of cherry-picking select business and other high volume/low cost customers. Because most smaller rural carriers have a rather discrete business/high volume customer base, this cherry picking strategy may have a draconian impact. The few large business customers in a smaller rural carriers service area thus become enormously important. In other words, if the Big Three are able to cherry pick away the few key business customers, smaller carriers may be left with little more than a disproportionate number of high cost residential customers (the most unattractive competitive target for the Big Three).[17] These risks are yet to be fully assessed by capital markets.

Competition may also be particularly perilous to smaller rural carriers due to the dramatic advantages enjoyed by the large new entrants into the local market. The Big Three have tremendous capital resources that vastly outstrip anything a small rural

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[16] Norberto Santana Jr., *AT&T Answers Criticism Over Long-Distance Failure*, Daily News (Sept. 26, 1998).

[17] *See* Comments of the United States Telephone Association, et al., Testimony of Dr. William E. Avera, CFA, CC Docket No. 98-166 (filed Jan. 19, 1998) ("Avera Testimony").

carrier may muster. Moreover, the Big Three have existing relationships with most customers due to their long distance service. The Big Three also enjoy a distinct advantage in their extensive marketing and technological capacities. They are far more firmly established as brand names and more developed technologically than smaller rural carriers. Thus the 1996 Act has presented investors in smaller rural carriers with substantial risks.[18] This is not to say that smaller rural carriers cannot compete and survive, but the competitive risks inherent in the new regulatory regime have never been assessed in setting a rate of return. In fact, these risks and opportunities remain largely undefined, making efforts to prescribe an accurate rate today problematic at best.

Changes in the competitive landscape are also not limited to traditional wireline providers.[19] Wireless carriers, cable companies, and Internet telephony are all in the process of transforming the telecommunications marketplace. These competitive options pose new and unique challenges to smaller carriers. Today these competitors are still in their infancies in many rural markets. Yet in the next few years, the marketplace is likely to change drastically. These new competitive options will bring corresponding increases in the cost of capital necessary for smaller rural carriers to

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[18] Unfortunately, competition presents only limited opportunities for smaller rural carriers. Vitelco has no contiguous carriers, which would provide a beachhead to new markets.

[19] *See* Avera Testimony.

compete, thus underscoring the need for the Commission to refrain from tampering with the current prescription until the new marketplace takes shape.[20]

III. Rate Represcription Will Actually Harm Competition.

Not only is rate represcription premature and fails to account for the evolving competitive and regulatory landscape, reducing the allowed rate of return may actually undermine the Commission's competitive goals. A reduction in the rate of return would hinder competition: (1) by decreasing profit margins for all carriers and (2) decreasing the capital available to competitive providers.

First, the Commission should be wary that any decrease in the rate prescription may actually delay competitive wireline entry.[21] ILECs, by definition, initially set the price ceiling for various services. Competitive providers, in order to succeed, must provide their services at, or below, the ILEC rate and still be able to make a profit. By lowering the price ceiling through a reduction in the cost of capital, local entry will thus become less attractive. The Commission is already well aware of the lackluster efforts of the Big Three to compete for local residential customers. A reduction in the rate of return will only exacerbate this disinterest in competing.

Second, a reduction in the permissible cost of capital will undermine competitive carriers' capitalization efforts as well.[22] This impact may not be felt by the Big Three, but small competitive local carriers may well be adversely affected by the proposed

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[20] *See* Avera Testimony.

[21] *See generally* Avera Testimony.

[22] *See generally* Avera Testimony.

change in the unitary rate of return. As all carriers have moved to upgrade their networks to compete more effectively, there has been a "squeezing out" effect. Smaller carriers have a harder time finding capital when so many players are competing for the telecommunications investment dollar. If the Commission were now to signal that the margin for providing local service is to be uniformly decreased, the remaining sources of capital may well further evaporate. At this vital time, the Commission should not undermine its long term competitive goals with a short term mechanistic modification of the rate of return.

CONCLUSION

For the foregoing reasons, the Commission should decline to alter its current authorized unitary rate of return.

Respectfully submitted,

Gregory J. Vogt

Gregory J. Vogt
Bryan N. Tramont
WILEY, REIN & FIELDING
1776 K Street, N.W.
Washington, D.C. 20006
(202) 719-7000

Attorneys for Virgin Islands Telephone Corporation

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VITELCO DESIGNATION FOR SERVICE

Pursuant to 47 C.F.R. § 65.100(b) and the Commission's Notice in the above-referenced proceeding, the Virgin Islands Telephone Company (Vitelco) hereby designates the following individual to receive service of documents and other materials in this proceeding:

Gregory J. Vogt
Wiley Rein & Fielding
1776 K Street, NW
Washington, DC 20006

Respectfully submitted

Gregory J. Vogt

Gregory J. Vogt
Bryan N. Tramont
WILEY, REIN & FIELDING
1776 K Street, N.W.
Washington, D.C. 20006
(202) 719-7000

Attorneys for Virgin Islands Telephone Corporation